



## Early Journal Content on JSTOR, Free to Anyone in the World

This article is one of nearly 500,000 scholarly works digitized and made freely available to everyone in the world by JSTOR.

Known as the Early Journal Content, this set of works include research articles, news, letters, and other writings published in more than 200 of the oldest leading academic journals. The works date from the mid-seventeenth to the early twentieth centuries.

We encourage people to read and share the Early Journal Content openly and to tell others that this resource exists. People may post this content online or redistribute in any way for non-commercial purposes.

Read more about Early Journal Content at <http://about.jstor.org/participate-jstor/individuals/early-journal-content>.

JSTOR is a digital library of academic journals, books, and primary source objects. JSTOR helps people discover, use, and build upon a wide range of content through a powerful research and teaching platform, and preserves this content for future generations. JSTOR is part of ITHAKA, a not-for-profit organization that also includes Ithaka S+R and Portico. For more information about JSTOR, please contact [support@jstor.org](mailto:support@jstor.org).

## THE BANK-NOTE ISSUE OF THE PROPOSED FEDERAL RESERVE BANKS<sup>1</sup>

E. W. KEMMERER

Professor of Economics and Finance, Princeton University

THE chief criteria by which we judge the success of a bank-note system may be expressed in three questions: (1) Are the notes well secured? (2) Are they promptly convertible into standard money at convenient places? (3) Does their circulation readily expand and contract with the needs of trade? Let us subject the note-issue provisions of the Glass-Owen bill to this threefold test of ultimate security, prompt convertibility, and elasticity.

### I

The security behind this bank-note issue will consist of the following items: (1) An amount of notes and bills of exchange, with short maturities, arising out of commercial transactions, which shall be equal to the amount of bank notes issued; these commercial assets to be segregated, in the custody of an official of the bank appointed by the Federal Reserve Board, for the protection of the bank-notes.<sup>2</sup> The segregated notes and bills must all represent commercial transactions of a type approved by the Federal Reserve Board, and must bear in addition to the names of the men or concerns who issue and endorse them, the name of at least one member bank. (2) Additional security without limit which may be required at any time by the Federal Reserve Board to protect the notes. (3) A segregated lawful-money reserve fund of not less than 33 $\frac{1}{3}$ %. (4) A first and paramount lien on all the assets of the issuing bank. (5) Acceptability for all taxes, customs, and other public dues. (6) What amounts to an absolute guaranty by the United States government.

<sup>1</sup> Read at the meeting of the Academy of Political Science, October 15, 1913.

<sup>2</sup> Secs. 17 and 14.

It is to be remembered that in addition to all this security, the amount of the issue is subjected to the two limitations *that notes can be issued only when applied for by the boards of directors of regional banks*, and that such applications must in every case receive the approval of the Federal Reserve Board. There would seem to be, therefore, absolutely no question of the safety of the notes. They will be even more secure than the present bond-secured national bank notes—and the safety of these no one questions.

The chief criticism of this feature of the bill relates to the government's responsibility for the ultimate redemption of the notes, a corollary of which is that the notes should be issued to the regional banks by an official or body representing the government. It is urged that this provision of the bill has a strong smack of greenbackism, that it is unscientific and sets a precedent in the direction of the issue of government paper money. Critics argue that the government's guaranty is useless, the notes being adequately protected without it, and that in time of great national danger the government's responsibility for the note issue might greatly impair its credit. Obviously it is self-contradictory to argue, first, that the government's guaranty is of no value in protecting the notes since they are fully protected without it, and second, that such a guaranty would be dangerous to the national welfare in time of war because it would impair the credit of the government. Assuredly the government's guaranty could not impair its credit unless it supported the credit of the bank. In normal times the government's guaranty would undoubtedly add little or nothing to the public's confidence in the notes, and *per contra* would make no draft upon the government's credit. But it is not for normal times that the government's guaranty is asked. It is for times of great emergency, when the stability of the note issue is threatened, and when we are in danger of being forced to a depreciated currency basis. Then, and then only, is the government's credit liable to be called upon. In such an emergency, it is difficult to imagine any purpose more important for the exercise of the government's credit than to keep the country upon a specie-paying

basis. Have we forgotten how the depreciation of the greenbacks demoralized business, played fast and loose with the equities between debtor and creditor, impaired the nation's credit, and increased by hundreds of millions of dollars the cost of the civil war? In times of great emergency the government can afford to increase many fold its tax burden, and to borrow money at exorbitant rates of interest. It cannot afford, except as the price of national existence itself, to let its circulating medium become debased.

But suppose the provision making the government ultimately responsible for the bank notes be stricken from the bill. Will the government thereby be freed from the responsibility? A lawyer, with his eye on the letter of the law, might say yes. A statesman or a social philosopher would unhesitatingly say no. When the government gives to a politically appointed body like the Federal Reserve Board great power, it assumes, through that board, great responsibility. If the notes depreciate or even threaten to depreciate, that fact will be proof that the Federal Reserve Board has failed to exercise properly and effectively its great regulating and conserving powers. The government would be morally responsible for the integrity of the note issue even without any legal responsibility, and the public would hold it so. The force of this responsibility is made more evident when we remember that these notes are receivable for all taxes, customs and other public dues; that they will presumably be held as legal reserve money by non-member banks, and that the banks issuing them are the sole depositories of government funds and the fiscal agents of the government. With or without the guaranty the government's credit is at stake. Why is it so dangerous to admit it frankly and to make the obligation legal as well as moral?

This government responsibility is not a new thing: our present national bank notes are issued by the government to the banks and the government assumes an unlimited liability for their payment. Have these facts led to an overissue of the notes or impaired the government's credit?

## II

Does the bill provide adequately for prompt convertibility of the notes into standard money at convenient places?

The places at which the notes are redeemable call for no criticism on the ground of public convenience. These places are: (1) The Treasury Department at Washington, where the Federal Reserve Board is authorized to require the issuing banks, as at present, to keep a five-per-cent gold redemption fund in the United States treasury, and (2) the offices of all the regional banks, which presumably include all the branches.

Much has been said in criticism of the bill for not making the notes redeemable specifically in gold, instead of in lawful money. In this respect, the bill follows the present practise as regards national bank notes, and it will be recalled that the Aldrich plan likewise called for redemption in lawful money. In my judgment, the bill would be strengthened if both notes and deposits were made payable in gold. The fact that deposits in regional banks count as reserves of member banks, while bank notes of regional banks cannot be counted as reserve money by member banks, makes it especially desirable that the deposits as well as the notes be made redeemable in gold.

In support of the claim that the notes should be redeemable in lawful money, it may be plausibly argued that all of our present lawful money (*i. e.*, lawful reserve money for national banks) except the silver (and the minor coins) is specifically redeemable in gold on demand at the United States treasury, and that the Secretary of the Treasury is under a legal obligation to maintain the parity of all kinds of money with gold; furthermore, that the proportion of our total lawful money and of the total money in the country of all kinds, consisting of gold, has been very rapidly increasing in recent years. In 1900, 49% of the lawful money in the country was gold. By 1913, the percentage of gold had risen to 63%. While the gold lawful money of the country has increased 108% since 1900, the other lawful money has increased but 16%. From such figures it may be argued that greenbacks and silver are rapidly becoming an unimportant part of our cir-

culating media, and that, as a consequence, the problems they formerly raised are solving themselves.

This argument carries much weight. But in its application to the question as to whether the obligations of the regional banks should be made specifically payable in gold or not, it contains one doubtful assumption. It is the assumption that after the enactment of the new bill, the same large proportion of gold will be continued. One of the great merits of the proposed legislation is that it will render more efficient our monetary and banking mechanism. Great economies in the use of money and credit will be effected. Our reserve money will be more efficient because better mobilized. There will be important economies in exchange transactions between different sections of the country and much less money will be kept in transit. Many millions of dollars now hoarded in the sub-treasury vaults will be released for active circulation. Provisions for greater currency and credit elasticity will relieve us of the necessity of keeping much idle money in slack periods of the year in order to be prepared for the demands of the active seasons like the crop-moving period. And finally, outside of the bank reserves of member banks, the new federal reserve notes will perform every money function now performed by gold certificates, a fact that will almost certainly result in the substitution in general circulation, on a considerable scale, of federal reserve notes for gold certificates—that is, a paper money with a minimum lawful-money reserve of  $33\frac{1}{3}\%$  for one with a minimum gold reserve of 100%. A regional bank can withdraw gold certificates from circulation, thereby making a vacuum in the paper-money circulation, for federal reserve notes, can present these certificates to the treasury for gold, and use the gold as a  $33\frac{1}{3}\%$  reserve against the federal reserve notes issued to fill the vacuum created by the withdrawal of the gold certificates. The result will be great and valuable economy in the use of gold and other money, leading to an outflow of that money which has become relatively redundant. Inasmuch as gold is the only money which has a world market, the outflow of redundant money will be in the form of gold. Of course, this will represent a real social economy. We shall have a less expensive but equally

safe and more efficient money and credit system. The released gold will bring back to us approximately its equivalent value in goods. But an incidental result will be that a larger proportion of our currency will be non-gold money and a smaller proportion gold. An effective method of preventing this transformation from going too far would be to require the legal minimum reserves of the regional banks to be held in gold. This demand, together with the demand for gold for the cash reserves of member banks, would assure an adequate gold basis for our circulation.

Another defect in the bill is the small minimum reserve requirement for regional banks, namely,  $33\frac{1}{3}\%$ . This is an absolute minimum for notes, but merely a normal minimum for deposits, and the reserve against deposits may be reduced below  $33\frac{1}{3}\%$  upon payment of a tax on the deficiency. This minimum reserve requirement is too small, both for notes and for deposits. The reserves of the regional banks will be chiefly reserves against bankers' deposits, which deposits are themselves reserves. Upon the reserves of the regional banks as a foundation, therefore, will rest a very substantial part of the current bank credit of the country. If a minimum legal reserve requirement is to be made at all—and conditions in the United States seem to demand it—that requirement should be large enough to inspire confidence.

There is no legal minimum reserve requirement for the Bank of England or the Bank of France, but the former normally keeps from 45 to 55% against its deposits, and at the present time has approximately 60%, while the latter normally keeps from 70 to 80% against both notes and deposits. For the Reichsbank, there is a minimum reserve requirement against notes of  $33\frac{1}{3}\%$ , but the Reichsbank normally keeps more than twice this minimum legal reserve against notes and from 50 to 60% against all demand liabilities. Doubtless most of the regional banks would normally maintain reserves well above the legal requirement, but the tradition among bankers in this country is to run close to the lawful minimum reserve, and it is not unreasonable to expect that some of the regional banks might be disposed to follow this tradition. It is easier to reduce a legal

reserve requirement than to raise it, and it would be well at the beginning to avoid fixing it too low. Perhaps the 50% reserve proposed in the National Monetary Commission's plan is too high, but it is believed that it would be unwise to make the normal minimum less than 40% for both notes and deposits.

This increase to 40% is made the more urgent since the bill, by recent amendments, has made such substantial reductions in the total reserves required of national banks and in the requirements for cash on hand.

From the standpoint of reserves, both deposits and notes should be treated alike, each being a demand liability of the regional bank, and I can see no need of segregating the reserve against notes or of treating it otherwise than that against deposits. The peculiar interests of the noteholders are amply protected in other ways, namely, by the segregated commercial-paper assets, the prior lien and the government liability.

### III

The third criterion by which to judge a note issue is that of elasticity. Will the proposed federal reserve notes promptly expand and contract according to the needs of trade, as do the notes of the Canadian chartered banks, or will they prove rigid and unresponsive to trade demands, like our present bond-secured notes?

The facts that these notes are issuable only against rediscounted commercial paper with short maturities, that they cannot be counted as reserve money of member banks, and that when the notes of any regional banks are received at the head office or branches of any of the other eleven banks or at the United States treasury, they cannot be paid out again, but must be returned to the issuing bank, alone will provide an adequate elasticity. Under such regulations, notes can be kept in circulation only when trade conditions demand them, and their continual return to the issuing bank will prevent a redundant circulation.

I can see no justification for the provision of the bill <sup>1</sup>

<sup>1</sup> Sec. 13, page 32, 11, 14 to 17.

requiring the Federal Reserve Board to fix a "rate of interest" of not less than  $\frac{1}{2}\%$  upon the federal reserve notes turned over to regional banks. Such a tax—it is in reality a tax and not an interest rate as the bill terms it—would add nothing to the effectiveness of the mechanism already mentioned for preventing a redundancy of note circulation. If the burden of this tax should fall directly upon the regional banks, it would probably come largely out of the government's share of the profits. If it should be shifted to the ultimate borrower, through higher rediscount rates on the part of the regional banks and resulting higher discount rates on the part of the member banks, it would fall upon those borrowers who took the proceeds of their loans in deposits, as well as upon those who took them in notes, and would be a needless burden on commerce. The borrowing bank has its choice as to the form of credit, deposit or bank notes, in which it will take the proceeds of its rediscounts. On both forms, the rate of discount is the same. A deposit credit and a note credit with a regional bank are interchangeable on demand; the notes may be deposited, or the deposits may be checked against for notes. Inasmuch as the deposit can be counted as lawful reserve money by member banks and therefore serve as the basis of further credit expansion, while the note credit cannot, the danger of an over-expansion of credit is more likely to be in the form of deposit credit than of note credit. Furthermore, to strike out this tax provision would result in eliminating a possibly dangerous arbitrary power in the hands of the Federal Reserve Board.

The best method of putting on pressure to check an over-expansion of credit is to apply a graduated tax to reserve deficiencies, measured against both notes and deposits. This brings the pressure to bear upon both forms of credit expansion, and applies it at the crucial point, namely, the reserve. The rate of such a tax should be specifically fixed in the law, so that the regional banks, the member banks and the public can foresee its application and adjust their affairs to it in advance. In any such institution as the one proposed, a certain amount of arbitrary power must be given to the governing body. The presumption, however, is always in

favor of devices that work automatically. They function more smoothly, and since it is possible to anticipate their workings, they will be less liable to produce sudden shocks. In the world of finance, there is no truer adage than the old one, "Forewarned is forearmed." I would suggest that the deficiency reserve tax be fixed at, say,  $1\frac{1}{2}\%$  for each  $2\frac{1}{2}\%$  or fraction thereof that the reserve falls below 40%, until the reserve reaches 30%, and then that the tax be doubled. But there should be no absolute stone-wall limit beyond which the reserve could not be reduced, providing the tax were paid.

With the adoption of these minor changes, I should expect the Glass-Owen bill to provide a bank-note circulation that would meet well the three great tests of a good bank-note—ultimate security, prompt convertibility, and elasticity.

In this paper I have confined myself to these three fundamental features of the note issue. The question of what shall be done with the present two-per-cent bonds is an important one, and one now urgently demanding from the administration prompt assurances of a fair answer. It does not fall properly within the scope of this paper, but I cannot leave the subject without saying that in the interest of the future credit of our government, and much more in the interest of that sense of generous honesty and fair play which we all like to attribute to the nation we honor, the government should make ample provision to assure the holders of the two per cents, for whatever purpose they were bought, of receiving full par value for their bonds. I believe firmly that national banks should be compelled to come into the new system. If they wish to enjoy a national charter and the privileges such a charter confers they must expect to play the game according to the national rules. They are given a year to decide. If they do not wish to avail themselves of the privileges and to assume the obligations which the government requires in the public interest for banks under federal charters, they should retire from the national system. It would be petty and wrong, however, for the government to enforce such a compulsion by a financial penalty that involves the repudiation of a clearly implied moral obligation. I cannot believe for a moment that the government will adopt such a course.